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June 16, 2008

AGENDA ITEM 7a

TO: MEMBERS OF THE INVESTMENT COMMITTEE

I. SUBJECT: Securities Lending Annual Review

II. PROGRAM: Securities Lending

III. RECOMMENDATION: Information only

* (Please refer to Attachment 1 for Wilshire's opinion letter)

IV. ANALYSIS:

Program History

The CalPERS Securities Lending Program started in the early 1980's. The program was initiated in an effort to earn additional income on the existing CalPERS portfolios. Historically, CalPERS utilized a traditional custodial and third party agency lending structure to manage the securities lending program. The program was viewed as a back office / administrative function, with management focus devoted primarily to compliance monitoring and cash reinvestment risks.

In 1999, staff proposed separating the lending function from the cash reinvestment function. In CalPERS' traditional securities lending model, the agent lent out securities and re-invested the cash pledged as collateral for that loan. The separation of the lending function from the cash reinvestment function optimizes the value of securities on loan and allows for the separation and optimization of the cash management duties from the agency lender.

Recognizing the potential for substantially greater income from an actively managed, lending approach, CalPERS co-developed an auction-based model with United Asset Management. That effort came to be known as eSecLending (eSec). CalPERS and eSec developed an online, web-based system as a means to maximize the value of lendable assets through an auction based

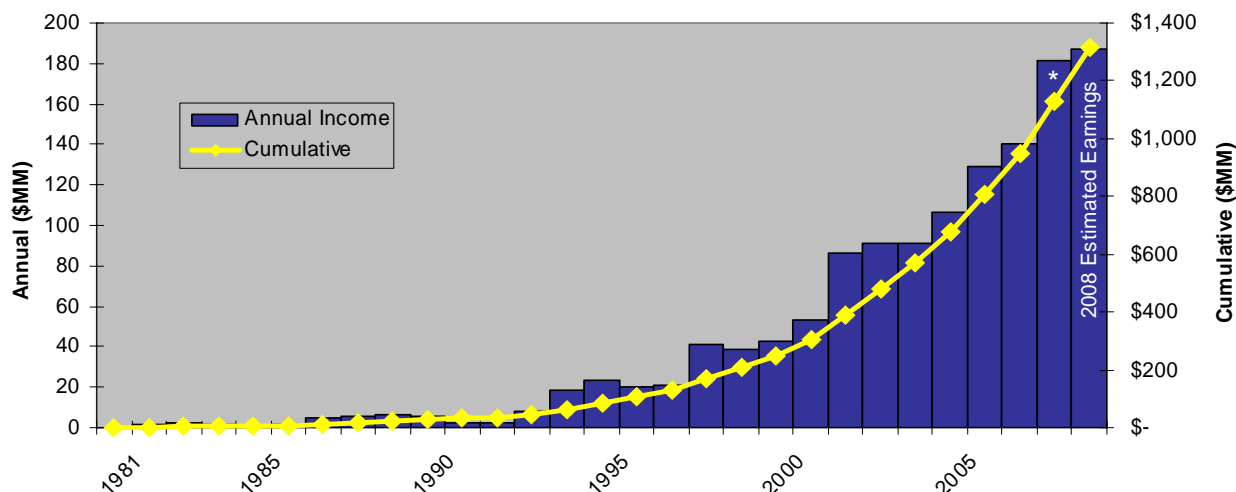
platform. The initial objectives of the CalPERS actively managed program included:

- Separating the cash management reinvestment function from the lending function
- Increasing program control through active management
- Utilizing the auction process as a price discovery mechanism
- Creating a transparent allocation process for the placement of securities lending assets
- Utilizing the power of the Internet to facilitate communications between lender and borrower

CalPERS initial auctions were tremendously successful and immediately increased returns. Revenue increased by 63% the first year the auction process was utilized. The increased price transparency of the auction format allowed CalPERS to realize the true value of its lendable asset base. By increasing the number of counterparties and creating portfolio subsets that matched borrower needs, CalPERS extracted more value from its existing asset base. In addition, the auction allowed for the separation of the cash management function from the lending function which led to moving a portion of the program's cash management function in house (see Attachment 2 for an overview of the internally managed cash reinvestment strategy).

Interest by counterparties in the auction process has grown since the first auction. Over the last eight years, CalPERS has auctioned off \$779 billion in assets through 30 separate auctions. CalPERS Securities Lending cumulative net earnings are nearly \$1.2 billion dollars. Over 73% of the total cumulative income has been generated in the last eight years, since moving to the auction based platform.

Net Program Earnings From Inception to Calendar Year End 2007 (\$MM)



* Annual and cumulative earnings do not include unrealized loss on the internal collateral reinvestment fund.

Program Summary

Earnings for the year ending March 31, 2008, are presented to the Investment Committee for information.

	Avg. Lendable Assets (\$000)	Avg. % on Loan	Earnings (Annualized)	Income to CalPERS (\$000)
Asset Class Earnings				
Global Equities	\$ 111,717,560	22.45%	12 bp	\$ 139,114
Global Fixed Income	\$ 35,135,237	50.39%	13 bp	\$ 44,973
Total Program Earnings	\$ 146,852,797			\$ 184,087
Unrealized loss on internal collateral reinvestment				\$ (508,782) *
Total Program Earnings including unrealized loss				\$ (324,695)

*Unrealized losses resulted from CalPERS use of mark-to-market accounting on the valuation of the internal cash pool, which is not market convention on collateral reinvestment pools.

The \$184 million earned this year is the highest year on record for the securities lending program. All four auctions over the past twelve months have been extremely successful, with over \$110 billion in assets awarded in 63 lots to 20 bidders. The incredible demand witnessed in our auctions resulted in record earnings from lending income, with over 96% of lending fees coming from

principle or exclusive awards from the auctions. This success reinforces the value of the auction platform and the demand in the marketplace to borrow CalPERS' assets.

Additional highlights over the past year include entrance into three new lending markets and a continued effort to bring cash collateral in house. Staff initiated lending in Turkey, South Korea and Mexico. Also, staff was able to bring in an additional \$5.3 billion in cash to be managed internally.

Cash Reinvestment Summary

The strategy utilized by the CalPERS securities lending group is to have our external partners manage the cash reinvestment liquidity needs and continue transitioning the "core" portion of the securities lending reinvestment assets from external managers to CalPERS internal Fixed Income unit. The "core" nature of a significant portion of the securities lending cash reinvestment assets provides the opportunity to take a longer-term perspective horizon when it comes to the management of the assets. A longer investment time horizon allows trading off the potentially increased monthly variability of investment returns in exchange for higher expected long-term returns. In addition the movement of cash reinvestment in house produces cost savings from the elimination of management fees to external managers. To date, CalPERS manages approximately \$18 billion or 51% of the Securities Lending cash collateral in house.

The short-term fixed income markets have witnessed unprecedented volatility over the last several months, resulting in a lack of liquidity throughout the short-term market. This crisis, which started in the sub-prime market moved quickly into other areas within the structured product market. As a result, pricing was affected even for the highest quality securities. This unprecedented stress has placed pressure on the mark-to-market valuation on our internally managed cash portfolio.

As a result of using mark-to-market valuation, the \$18 billion internal cash collateral portfolio recorded an unrealized loss of \$509 million as of March 31, 2008. Although the securities lending industry and CalPERS external securities lending cash pools use book value accounting, CalPERS internally managed cash reinvestment portfolios used mark to market accounting at inception to be consistent with all internally managed CalPERS portfolios. The internal portfolio is of very high quality and ultimately in staff's opinion "money good"; however the timing of the expected reversal of the unrealized loss is expected to take place over the next one to two years as the securities mature.

The last twelve months has been a dichotomous journey. The liquidity crunch significantly impacted our cash collateral pools. However we witnessed record earnings and tremendous demand to borrow CalPERS securities.

V. STRATEGIC PLAN:

This program contributes to the achievement of Goal VIII of the Strategic Plan by providing low risk incremental returns to the Fund.

VI. RESULTS/COSTS:

The securities lending program generated \$184 million of revenue for the year ended March 31, 2008, which was offset by an unrealized loss of \$509 million. Total program earnings including the unrealized loss were \$(325) million. The average market value of securities on loan for the year was \$42.7 billion.

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